

I. INTRODUCTION

Any assessment of bank capital must, by necessity, include deposit structure and liquidity considerations. Proper structuring of earning assets is also incomplete and ineffective without consideration of deposit and other funding sources, inasmuch as the cost of funds comprises the most significant portion of a bank's total expenses and therefore has a profound effect on bank earnings. Deposits also represent an important element of both liquidity and funds management and must be reviewed in concert with that area. In summary, analysis of a bank's capital adequacy, earnings capacity, liquidity position and management's skill at administering or adjusting these elements and their interrelationships is incomplete without an evaluation of the impact of the structure and characteristics of the institution's funding sources on these factors. This section of the Manual discusses the major items with which examiners need to be familiar in order to perform an adequate assessment of a bank's deposit accounts and other funding sources and determine their influence on the safe and sound operation of the institution.

II. FUNDING SOURCES

Major changes have taken place in the cost and structure of bank deposits and other funding liabilities. For example, basic assumptions and operating policies concerning the relationship between depositors and borrowers have been altered, because both depositors and borrowers earn and pay market rates of interest on their funds. This fundamental change has occurred because of relaxation of statutory or regulatory restrictions on maximum rates banks may earn on their assets or pay on their liabilities.

The traditional distinctions between demand, time, and savings deposits have faded. From an operational and managerial standpoint, the concept of "purchased funds" has displaced traditional distinctions between deposits and borrowings. Deregulation and increased competition for funds from both banking and nonbanking financial intermediaries accelerated this development.

Transaction accounts, or deposit accounts from

which the depositor is permitted withdrawals by negotiable instrument, payment orders of withdrawal, and telephone transfer or similar device for payment to a third party or others, have become commonplace and have brought about changes in banks' overall deposit structures. In addition to demand deposits, transaction accounts include NOW accounts, accounts which can be accessed by a debit card, automatic transfer accounts, and some telephone transfer accounts. The most significant of these are the various versions of the interest-bearing transaction account. With the availability of these accounts, depositors are more inclined to maintain lower balances in traditional demand deposits and more funds in interest-bearing accounts because of the interest earned and the ease and speed with which funds may be transferred among or withdrawn from these accounts. Transaction accounts must, however, be appropriately priced to offset the added interest cost, or earnings will be adversely affected. The following factors should be considered in evaluating the effect of interest-bearing transaction accounts on the bank's earnings: Estimated interest expense resulting from a transfer of funds from interest-free demand accounts; Service charge income; Projected operating cost; Changes in required reserves; Promotional and advertising cost; and Quality of management's planning.

The Uniform Bank Performance Report (UBPR) is an analytical tool which shows the impact of management decisions and economic conditions on a bank's earnings performance and balance sheet composition. Parts of the UBPR can be employed to analyze the impact of a bank's deposit structure on the capital, asset, management, earnings and liquidity components of the Uniform Bank Rating system. Throughout the UBPR, deposits and associated interest expenses are measured against various operating or balance sheet ratios and compared to peer performance. Generally, five-year trends are presented. The UBPR utilizes a net interest format. Cost factors for deposit categories and other interest-bearing funding liabilities are displayed along with balance sheet and trend analyses. Deposit dollar amounts and percentage compositions are included. The importance of deposits can be reviewed in tables on sources and uses of funds. Finally, the impact of deposit costs is displayed as related to margin sensitivity

analysis, the bank's liquidity position and investment portfolio.

Borrowings

Some banks have become active solicitors of funds in the open markets, employing certain borrowing techniques as a management tool and a means of enhancing profitability. Liabilities such as Federal funds purchased and instruments closely resembling borrowings, such as negotiable certificates of deposit, are employed. More recently, Eurodollars, commercial paper issued by bank holding companies, and other instruments have been developed and used as sources of funds. The use of such borrowing or near borrowing techniques requires especially skilled and knowledgeable management as well as the exercise of extreme care to avoid the pitfalls coincident with an overextended borrowing position.

Borrowing is obviously subject to criticism if precipitated by poorly planned funds management practices. Borrowings are justified if they serve one or more of the following purposes:

1. To meet the temporary or seasonal loan or cash requirements of the bank's customers if the growing period is indeed temporary and the bank is quickly restored to a position where the quantity of its principal earning assets and cash reserves are in proper relationship to the requirements of its normal deposit volume.
2. To meet large and unanticipated deposit withdrawals which may arise during periods of economic distress. The examiner should distinguish between "large and unanticipated deposit withdrawals" and a predeterminable contraction of deposits that might, for example, be occasioned by the cessation of activities in a resort community or withdrawal of funds on which the bank received adequate prior withdrawal notice. Those should be met through ample cash reserves and readily convertible assets rather than by borrowing.
3. To serve as an effective management tool, i.e., liability management, whereby banks engaged in money market transactions may borrow on a more or less continuous basis. Generally, the effective use of this type of

borrowing is limited to money center or large regional banks.

When a bank requires funds, the method selected (i.e., short-term borrowings or sale of longer-term assets, or both), will be determined by the market value of the salable assets, prevailing interest rates, and the bank's earning position and related tax considerations. Either method may adversely affect a bank's liquidity, earnings and capital posture. The risks pointed out in the Liquidity and Funds Management section of this Manual with respect to liability management are especially applicable here and should be reviewed.

A thorough analysis of the purpose of engaging in borrowing activity and the exposure to risk inherent in such activity must be made during the examination and related to the other aspects of the bank's operations. The principal sources of borrowings, the range of amounts, frequency, length of time indebted, and reasons provided by management for such borrowings should be explored. A verification should be made of actual use of funds, that is, whether they were used to meet such demands as seasonal deposit fluctuations, inaccurate projections of loan growth, or overextensions in loans or investments. If an unwarranted and potentially dangerous net borrowing position is encountered, examiners should make appropriate comments in the examination report and pursue appropriate remedial measures.

Domestic Borrowings

Domestic borrowings may take a variety of forms, such as sales of participations in pools of securities, issuance of due bills representing obligations to deliver securities, execution of promissory notes and rediscounting of notes and bills. The most common sources and instruments that provide short-term, nondeposit funds are discussed below.

Federal Funds Purchased - Federal funds are, technically, deposit balances held by Federal Reserve Banks which, together with vault cash, represent the legal reserves member banks are required to maintain. The Federal funds market is described as one in which commercial banks borrow and lend excess reserve balances held at the Federal Reserve. However, growth and change in the market have made this description deficient, as many market participants, including

most State nonmember banks, do not maintain balances at the Federal Reserve. Moreover, a Federal funds transaction does not necessarily involve transfer of a reserve balance, as in the case of banks borrowing excess balances from their correspondent banks.

The lending and borrowing of these balances has become a convenient method employed by banks to avoid reserve deficiencies or invest excess reserves over a short period of time. In most instances, Federal funds transactions take the form of overnight or over-the-weekend, unsecured transfers of immediately available funds between banks. However, banks also enter into continuing contracts having no set maturity but subject to cancellation upon notice by either party to the transaction. Banks also engage in Federal funds transactions of a set maturity, but these comprise only a small percentage of all Federal funds transactions. While the overnight or over-the-weekend technique prevails, these transactions may evolve into a continuing situation. This development is usually the result of liability management techniques whereby the buyer (borrower) attempts to utilize the acquired funds to support a rapid expansion of its loan-investment posture and as a means of enhancing profits. In any event, these transactions should be supported with written verification from the lending institution.

Federal Reserve Bank - Short-term credit is available to State nonmember banks at the discount window of Federal Reserve Banks. U.S. Government securities are the most acceptable and most common type of collateral in obtaining a Reserve Bank loan. Other acceptable collateral consists of municipal obligations and certain loans held by the borrowing bank. If an individual bank's borrowing becomes a regular occurrence, Reserve Bank officials will review the purpose of the borrowing and encourage the bank to initiate a program to eliminate the need for such borrowings.

Repurchase Transactions - Securities (Loans) Sold Under Repurchase Agreements - Instead of resorting to direct borrowing, a bank may sell assets to another bank or some other party and simultaneously agree to repurchase the assets at a specified time and at a prearranged price. Bank-owned securities, and to some extent loans, are sold under repurchase agreements to generate temporary working funds for liquidity purposes or

to invest in more favorable assets. The usual terms of sale of securities under a repurchase agreement require the seller, after a stated period of time, predominantly of short duration, to repurchase the same securities at a predetermined price or yield. U.S. Government securities, particularly short-term, are the most common type sold due to the safety factors, maturity, and presence of an established market to facilitate the sale.

If a bank sells any asset under an agreement to repurchase, whether the agreement is absolute or contingent upon some event such as default, or if it sells any asset with an endorsement or guarantee to pay in event of default, then the outstanding obligation is typically considered a form of borrowing.

Repurchase Transactions - Retail Repurchase Agreements (Retail Repos) - The Corporation has issued a Statement of Policy on Retail Repurchase Agreements (refer to the Prentice-Hall volumes) which discusses the appropriate disclosures of material facts of retail repo transactions to the bank's customer; guidelines with respect to the advertising and marketing of retail repos so as not to mislead the investing public; and various legal and safety and soundness issues involved in the issuance of retail repurchase agreements.

In order to qualify for exemption from the interest rate restrictions and prohibitions of Part 329, a retail repo must meet certain requirements. The obligation must:

1. Arise from a transfer of direct obligations of, or obligations that are fully guaranteed as to principal and interest by, the United States or any agency thereof ("Federal securities");
2. Be in denominations of less than \$100,000;
3. Mature in less than 90 days; and
4. Obligate the bank to repurchase the underlying Federal securities.

With regard to the first stipulation, banks are cautioned to closely examine the method of "transfer" of a government security to the buyer of a retail repo. Although "transfer" does not require transfer of title of the Federal securities that collateralize the retail repo, the FDIC recommends that banks perfect the customer's security interest

when it is possible to do so under State law. Additionally, substitution of different obligations for the original underlying security during the term of the repurchase agreement is inconsistent with the concept of "transfer". Moreover, substitution raises issues involving the Investment Company Act of 1940, in that the practice creates the appearance the bank is pooling funds to purchase securities. If so, registration might be required. To avoid this implication, the issuing bank should ensure that each underlying security is segregated and specifically identified as the Federal securities for a specific obligation of the bank. Further, it is the FDIC's view that the bank must own the underlying Federal securities at the time the retail repo interest is sold.

As indicated, the policy statement describes a retail repo as an obligation of the issuing bank which arises from a "...transfer of direct obligations of..." the U.S. Government or its agencies. The quoted phrase may be interpreted in such a way that a bank might collateralize its retail repo transactions with repurchase agreements in denominations in excess of \$100,000 (known as wholesale repos) purchased from other banks. However, there are several pitfalls associated with this approach, and the FDIC strongly discourages this practice. First, the requirement of adequate disclosure of all material information would seem very difficult to fulfill if the bank is frequently purchasing repos from other banks to secure its own retail repo obligations. Secondly, where a pool of securities is held as collateral for a single or continuous issue of retail repos, it may be impossible to establish a market value on those securities held subject to the security interest of another bank.

Retail repurchase agreements are essentially short-term, potentially volatile borrowings at market rates of interest. Contingency plans should provide for alternate sources of funds in the event of a run-off of repurchase agreement liabilities. In all regards, banks engaging in or planning to engage in the sale of retail repos are urged to consult with legal counsel competent in the field of securities law to determine what constitutes sufficient disclosure to customers as well as to ensure compliance with the antifraud and other applicable provisions of Federal and State securities law.

Treasury Tax and Loan Accounts - Banks

receiving Treasury Tax and Loan (TT&L) funds have the option of remitting those funds daily through a Federal Reserve bank (remittance option) or maintaining those funds in an interest-bearing, demand account (note option). The note option permits banks to retain the TT&L funds as secured, purchased funds callable on demand. Under the note option, such funds should be shown in the examination report as deposits on the day received and as "Other Borrowed Money" on the following day. As borrowed funds, they must be analyzed as any other volatile funding source which requires the encumbrance of assets for pledging purposes.

International Funding Sources

As in the case of domestic sources of funds, international funding may exist in a number of forms. The most common is the Eurodollar market. Virtually all large regional and multinational banking organizations and many smaller banks access this source. Eurodollar deposits are essentially dollar-denominated deposits taken by a bank's overseas branch or its international banking facility (IBF). They are free of reserve requirements and deposit insurance assessments. While the growth of this market is attributable to several factors, of primary importance to the examiner is the fact that this interbank market is highly volatile, and the bank's Eurodollar deposit-taking activity should be analyzed within the same context as all other potentially volatile funding sources.

III. DEPOSIT MANAGEMENT PROGRAM

The potentially critical role deposits play in a bank's ongoing successful operation clearly demonstrates the importance of implementing programs to retain and, in most instances, expand the deposit base and provide a means of monitoring the nature and volatility of the deposit structure. Increased competition for funds and the desire of most depositors to not only minimize idle, nonearning balances but also receive market rates of interest on invested balances have given further impetus to deposit retention efforts. An effective deposit management program should at a minimum include the following information:

1. A clearly defined marketing strategy;

2. Projections for deposit growth and structure;
3. Associated cost and interest rate scenarios;
4. Procedures to compare results against projections; and
5. Steps to revise the plan when needed.

Development of a deposit management program should take into account the make-up of the market area economic base; potential for investing deposits at acceptable margins; existing management competence; adequacy of bank operations; location and size of facilities; nature and degree of bank and nonbank competition; impact of local and national economic conditions; and the effect of monetary and fiscal policies of the Federal government on the bank's service area and money and capital markets in general.

Once a deposit development and retention program has been devised, it must be monitored and adjustments made as necessary. The long-range success of such a program is closely related to management's ability to detect the need for change as early as possible. Projections of deposit growth are, of course, important, but a determination must also be made of the make-up of the accounts as to stable deposits, fluctuating or seasonal deposits, and volatile deposits. Stable deposits are considered basically nonvolatile placements which will, in all likelihood, remain as long as the bank continues to offer satisfactory service and, most importantly, provide a return competitive with other investment alternatives (even if the actual rate of interest is subject to rapid and/or significant changes). Bank management should remain knowledgeable of the characteristics of the deposit structure via periodic internal reports. Lack of such knowledge could lead to the unwise employment of funds and subsequent problems.

IV. SAFETY AND SOUNDNESS CONSIDERATIONS

Public Funds

These deposits should be reviewed by examiners due to their size and potential volatility. Accounts

of public bodies typically fluctuate on a seasonal basis due to timing differences between tax collections and expenditures. Though regarded as generally volatile, these accounts may actually be reasonably stable over time or their fluctuations quite predictable. Therefore, investigation is often needed to make informed judgments as to their stability.

Large Depositors

For examination purposes, large deposits are defined as those concentrations of funds under one control, or payable to one entity, which aggregate 2% or more of the bank's total deposits. By virtue of their size, such deposits are considered to be potentially volatile liabilities, however, examiners may determine that certain large deposits actually remain relatively stable for long periods of time. In reviewing large deposits, the existence of related "Other Liabilities", such as borrowings and repurchase agreements, must not be overlooked, nor can associated loan or investment relationships be excluded from the analysis.

While the existence of some large deposit relationships is normal, examiners should attempt to determine if large deposit relationships were acquired in an unwholesome fashion such as the result of political influence, unsavory corporate arrangements, or to accommodate abusive insider relationships. Funds so obtained often lead to involvement in unsafe or unsound banking practices, and any such relationship should receive close scrutiny by examiners, and be appropriately covered in the examination report. A bank with a concentration of deposits in a limited number of accounts or substantial sums maturing simultaneously, should develop a loan and investment strategy which incorporates the potentially volatile nature of these deposits. Considerations should include pledging requirements, affiliated relationships, impact on liquidity and funds management, and the normally narrow interest spreads associated with large deposits. To the extent that fluctuations in deposit and loan volumes adversely coincide, that is, deposits are low when loans are high, special liquidity management measures must be taken.

While the comments above deal with large deposits, similar concerns and investigatory measures should be applied to other concentrated sources of funding.

Negotiable Certificates of Deposit

Negotiable certificates of deposit (herein referred to as "CDs") warrant special attention as a component of large deposits. They are usually issued by money center or large regional banks in denominations of \$1,000,000 or more and may be issued at face value with a stated rate of interest or at a discount similar to U.S. Treasury Bills. CDs of major banks are widely traded, may offer substantial liquidity, and are the underlying instruments for a market in financial futures. They are instruments ordinarily used to fund reinvestment goals of issuing banks as opposed to solving liquidity crises, although the latter could be the case. Their cost and availability are closely related to overall market conditions. Any adverse publicity involving either a particular bank or banks in general can impact the CD market. These CDs have many features of borrowings and can be quite volatile. The fundamental distinction between these accounts as deposits or borrowings is, at best, nebulous, but they are clearly a form of purchased funds. Intense competition for funds among financial intermediaries has led to common use of CDs. Thus, as a practical matter, drawing technical distinctions between CDs (except for the purposes of deposit insurance or deposit assessments) as borrowings or deposits is, in large measure, academic.

Brokered Deposits

The term "brokered deposit" means any deposit that is obtained from or through the mediation or assistance of a deposit broker. Brokered deposits usually exhibit highly volatile characteristics and often carry higher interest rates than alternative sources of funds.

The use of brokered deposits by problem institutions has often been associated with abuses and contributed to failures with consequent losses to the deposit insurance funds. They can represent consistent and heavy borrowings to support unsound or rapid expansion of loan and investment portfolios.

Section 29 of the FDI Act, implemented by Part 337 of the FDIC Rules and Regulations, limits the use of brokered deposits. An undercapitalized insured depository institution may not accept, renew, or roll over any brokered deposit. An adequately capitalized

insured depository institution may not accept, renew, or roll over any brokered deposit unless the institution has applied for and been granted a waiver by the FDIC. Only a well capitalized insured depository institution is allowed to solicit and accept, renew or roll over any brokered deposit without restriction.

Supervisory Policy - With respect to adequately-capitalized institutions, any safety and soundness concerns arising from the acceptance of brokered deposits are ordinarily addressed by the conditions imposed in granting the waiver. In monitoring such conditions, it is incumbent on the examiner not only to verify compliance but also to assess whether any unanticipated problems are being created.

The acceptance of brokered deposits by well-capitalized institutions is subject to the same considerations and concerns applicable to any other type of special funding. These concerns relate to volume, availability, cost, volatility, and maturities and how the use of such special funding fits into the institution's overall liability and liquidity management plans. There should be no particular stigma attached to the acceptance of brokered deposits per se and the proper use of such deposits should not be discouraged.

Deposit development and retention policies should recognize the following:

- The restrictions on accepting, renewing or rolling over brokered deposits;
- The limits imposed by prudent competition; and
- The pitfalls of uninformed reliance on brokered funds.

When brokered deposits are encountered in an institution, examiners should consider the effect on the overall funding and investment strategies of the institution, and verify compliance with Part 337. Any loans tied to specific brokered deposits should receive special scrutiny. Apparent violations of Part 337 or inappropriate use of brokered deposits should be discussed with management and the board of directors.

Secured and Preferred Deposits

Secured and preferred deposits impose pledging requirements upon banks. Banks must secure U.S. Government deposits, and most states authorize or require the pledge of assets to secure state and municipal deposits. Although several forms of security may be acceptable, U.S.

Government securities are the most commonly pledged. Many states also mandate that depositories secure trust department funds deposited in their own bank; bankruptcy court funds are often accorded similar treatment. In addition to strict regulatory or bookkeeping controls associated with pledging requirements, banks may establish various monitoring controls due to the impact pledging may have on liquidity. Accurate accounting for secured or preferred liabilities gains added importance during bank liquidations since certain secured depositors and creditors gain immediate access to a bank's most liquid assets.

Bank Investment Contracts

A Bank Investment Contract ("BIC") is a deposit contract between a bank and its customer that permits the customer to deposit funds over a period of time and obligates the bank to repay the amounts deposited plus interest at a guaranteed rate to the end of the contract term. The contract may range from six months to as long as ten years although, more typically, only three years. It is a non-transferable liability, i.e., not saleable in a secondary market. A BIC is the counterpart of the insurance industry's Guaranteed Investment Contract ("GIC"). The customers for BICs and GICs are, in most cases, sponsors of employee benefit plans such as pension plans or deferred compensation plans that qualify under section 401(k) of the Internal Revenue Code (commonly referred to as "401(k)Plans").

BICs have contractual terms that are marginally different from a traditional certificate of deposit ("CD"), i.e., a "deposit window" feature and a "benefit response" feature. The "window" feature is simply an initial period of time during which a pension plan sponsor or plan participants can deposit monies into a particular BIC contract. Any deposits made during this period earn the agreed upon contractual or indexed rate of interest for the life of the BIC contract. The "window" period may vary anywhere from a few months to a year. Based on a 1989 Federal Reserve survey, the median window period is six months, with no bank having a typical window period over one year. In an effort to limit the uncertainty concerning the amount of deposits that will be made during a "window" period, contracts frequently place limits on maximum deposit amounts and impose penalties if minimum deposit levels are not reached. Furthermore, it is

not uncommon for BICs to involve only an initial lump-sum deposit, i.e., not provide any "window" period for additional deposits.

The "benefit response" feature provides for withdrawals from a BIC to accommodate plan provisions that allow plan participants, under certain circumstances, to make withdrawals from the fixed-income option (the option that usually invests in BICs or GICs) at book value. Common circumstances under which withdrawals may be allowed prior to maturity of the BIC/GIC contract include retirement, disability, termination of employment, hardship, transfers to other investment options under the same retirement plan, and loans. Withdrawals may also take place because of corporate-initiated events, such as plant closings, reduction-in-force programs and ownership changes. Increasingly, penalty-free withdrawals are not allowed under many types of corporate-initiated events.

The following general guidance is offered regarding BICs whenever they are present in institutions examined by the FDIC. The principal risks associated with these deposit contracts are interest-rate risk and liquidity. In a declining interest-rate environment, the bank may receive more funds during the "window" period than anticipated or than can be employed in reasonably matched, sound and profitable investments. Conversely, in a rising interest-rate environment, the bank may receive less funds than anticipated and/or experience withdrawals greater than expected as the plan participants seek higher returns elsewhere. This, in turn, may create liquidity pressures depending on the volume of such funds held and commitments made.

Whenever BICs are found, examiners should initially review any stated policies of the bank specifically addressing the solicitation, management and investment of BIC funds, particularly policies addressing interest-rate risk, including hedging strategies, and how BIC funding fits into the bank's overall scheme of asset/liability management. In this context, particular attention should be paid to policies prescribing terms and conditions acceptable to the institution for "windows" and benefit response features in BICs.

The examiner should focus on the specifics of the bank's BIC funding to determine that its practices conform to stated policies and that those

practices do not pose an undue risk to the safety of the institution. To this end, the examiner should consider the volume, maturity, and cost of the BIC funding in relation to both the bank's other deposit and any nondeposit funding. The examiner should also consider the nature, quality, liquidity, and maturity of the assets supported with the BIC funding or, more generally, the entire asset structure of the bank when BIC funding is used for general funding purposes. In making this analysis, the examiner should be aware of the terms and conditions of the BIC contracts booked by the bank, that is, the time periods and conditions under which additional deposits or withdrawals may be made to or from such contracts, and the extent to which the bank has been anticipating accurately its cash flow from BIC funding and has planned accordingly.

Remote Disbursement Activities and Zero-Balance Accounts

In an effort to establish and/or maintain customer relationships, banks often provide cash management services to corporate accounts. Two of the more common services are remote disbursement services and zero-balance accounts. Remote disbursement is a technique which enables a customer to delay settlement of a financial transaction by taking advantage of the "float" possibilities in the check clearing system. The process occurs when the maker of a check draws the instrument payable at a bank remotely located ("remote bank") from the payee named in the instrument. Remote disbursement is often used in conjunction with zero-balance accounts which permit depositors to draw checks against accounts maintained at or near a zero-balance. A corporate customer utilizing this cash management approach generally maintains a primary deposit account relationship at a bank where the principal borrowing arrangements are maintained. This bank may be referred to as a "concentration bank" and through it the customer consolidates receipts and makes general disbursements.

Zero-balance accounts obviously cannot be considered funding sources for the remote bank. More importantly, they present a credit risk due to the fact that checks are paid on accounts with insufficient collected balances on the expectation that covering funds will be provided by the customer prior to the close of the business day. The intraday exposure to the remote bank, in the

form of unsecured lending against uncollected funds, is not reflected in the bank's financial statement. However, the amounts involved may be sizeable and even exceed the bank's capital.

Examiners should analyze the bank's cash management services. If a concentration bank is involved, the focus should be on the potential volatility corporate deposits as funding sources present. If a remote bank is involved, the supervisory interest centers on the exposure resulting from a practice of routinely paying checks against uncollected funds. The absence of prudent safeguards and full knowledge of the creditworthiness of the customer may expose the remote bank to large and unnecessary risks and warrants comment in the examination report and initiation of remedial measures.

Funds Transfer System Risk

Growth of the commercial banking industry accompanied by greater customer demand for services has increased the importance of wire transfer. Wire transfer has evolved from the use of elementary Morse code to sophisticated automated switching operations linking the Federal Reserve System with various governmental agencies and commercial banks. Functions of the wire transfer operation include daily funds transfers, securities transactions and the general communication of information.

Banks may effect transfers or related messages by mail, telephone and direct access to several telecommunications systems. The size and complexity of the operation will determine which method the bank uses. Since speed is the primary reason for many wire transfers, mail requests are infrequent. The majority of banks make transfers and execute Federal funds transactions over the telephone or teletype since their size and volume does not justify maintaining automated systems. However, the tendency to automate the operation is increasing with the advent of inexpensive computer technology.

The large-dollar networks are now an integral part of the payments and clearing mechanism. A variety of networks have been established to provide funds transfer services. They include the Federal Reserve Communications System (FedWire), the Clearing House Payments System (CHIPS) and Automated Clearing House (ACH).

The volume of funds which change hands daily in the U.S. through the electronic funds transfer environment is staggering. Present estimates place this volume at over one trillion dollars. It is therefore readily apparent why the financial institutions involved in those transactions and the regulatory authorities who supervise them are concerned with the quality of internal controls and management's awareness of the inherent risks associated with the various systems.

Risk Management - Errors and omissions and fraudulent alteration of the amount or account number to which funds are to be deposited could result in a loss to the bank. Costs can include loss of funds, loss of availability of funds, interest charges, and administrative expenses of recovering funds and correcting problems.

Banks are exposed to settlement risk whenever provisional funds are transferred. Provisional funds are irrevocable payments that are subject to final settlement at a later time. Two levels of risk are present

1. Credit risk to participating banks whose overdraft payments for customers (including nonsettling respondents) are not covered; and
2. Systemic risk to network participants when other participants fail to settle. There is no settlement risk to the recipient of a FedWire transfer. However, payments received through CHIPS are provisional and expose the recipients to settlement risk if funds are released prior to final settlement.

Intraday (or daylight) overdraft risk occurs when payments are released in expectation of the future receipt of covering funds. By definition, they represent credit exposures of a very short duration, usually a few hours. Overnight overdrafts result from failure to receive covering funds or intentional extensions of credit. In either case, a bank is exposed to risks resulting from payments made against insufficient funds or credit extensions.

The examination of funds transfer activities is designed to disclose deficiencies in the internal credit and operational controls of participating institutions and to assess the adequacy of the supervision of such activities by the senior

managements and boards of directors of those institutions.

Management is responsible for assessing the inherent risks in the system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of such safeguards. Bank supervisors have the responsibility of seeking to ensure that the financial institutions have evaluated their own risks realistically and have provided for accounting records and internal controls which are adequate to keep the exposures within acceptable limits.

Effective risk management requires that:

1. An adequate accounting system be in place to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments;
2. Payments be within established credit limits and that amounts in excess of such limits involving significant credit risk be properly approved by appropriate lending authorities; and
3. Institutions responsible for settling the positions of others assign responsibility at an appropriate supervisory level for monitoring respondents' accounts.

To assure that prudent banking practices are being followed by banking institutions in their funds transfer activities, examinations should focus, with equal emphasis, on the evaluation of credit risks and operational controls. Deficiencies disclosed in either of those areas and suggestions for improvement should be discussed with management and listed in the report of examination. Constructive criticism by the examiners should help the institutions strengthen procedures to minimize the risks associated with funds transfer activities.

V. ALL OTHER LIABILITIES

Mortgages Payable

Mortgages, liens and other encumbrances on premises, which the bank is legally obligated to pay, are shown in the examination report under

Other Borrowed Money. Premises should be carried on the books at its full value net of depreciation.

A common method used by banks to carry fixed assets indirectly is to transfer title to the property to an affiliate or subsidiary corporation formed for that purpose with a leaseback arrangement to the bank, hence the term "sale-leaseback" transaction. As a result, the mortgage or lien becomes the liability of the affiliate or subsidiary. However, since instructions for preparation of financial reports require consolidation of such subsidiaries, the fixed asset investment and debt liability of the bank are reflected. Additional information on sale-leaseback transactions is included in the Premises and Equipment Section of this Manual.

Capital Leases Outstanding

The FDIC has adopted the Financial Accounting Standards Board guidelines for reporting lease transactions as discussed in the Statement of Financial Accounting Standards No. 13, Accounting for Leases. The basic concept expressed by the Statement is that a lease transaction which substantially transfers all of the benefits and risks of property ownership should be accounted for by the lessee as the acquisition of an asset and the incurrence of a liability. Additional information on this subject is included in the Premises and Equipment Section of this Manual.

Accrued Taxes and Expenses

Instructions for the Preparation of Reports of Condition and Income require all banks, regardless of size to prepare financial reports on the basis of accrual accounting. A general category of other liabilities common to banks on an accrual system is accrued taxes and other expenses, which represent periodic charges to income for expenses not immediately payable but which have yielded benefits in the current period. Examples of such items include Federal income taxes, taxes on premises or equipment, interest on savings and time deposits and salary expense. "Reserve" accounts which consist of amounts accrued for taxes or other expenses should likewise be treated as liabilities.

Bankers Acceptances

A bankers acceptance is a time draft or bill of exchange, accepted by a bank, drawn by an individual or business firm on a bank ordering it to pay to the bearer or a designated party a certain sum of money at a specified time. If an acceptance executed by a bank or by others acting as its agent is outstanding (unmatured), it is a direct liability. The use of this instrument arises primarily from the financing of foreign trade, but it may also be used to finance the movement and storage of goods in domestic trade. An acceptance often originates under a letter of credit, but it is not treated as an acceptance until drafts or bills drawn against the letter of credit have been accepted by the bank. Bankers acceptances sold for the purpose of borrowing money should be identified as borrowings in the examination report. Acceptances owned (discounted or purchased) by the bank should be reported as loans. Additional information on this subject is included in the International Banking Section of this Manual.

All Other Liabilities

Examples of such liabilities include:

1. Deferred income taxes, arising from timing differences between the amounts of certain income and expense items reported for tax return and report purposes;
2. Deferred gains on futures contracts;
3. Dividends payable, representing cash dividends declared but not yet paid; and
4. Accumulated contract losses on forward and standby contracts.